Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements	**WC Docket No. 02-112**
2000 Biennial Regulatory Review Separate Affiliate Requirements of Section 64.1903 of the Commission's Rules	**CC Docket No. 00-175**

Reply Declaration

of

LEE L. SELWYN

on behalf of

AT&T Corp.

July 28, 2003

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REPLY DECLARATION OF LEE L. SELWYN

Introduction

Lee L. Selwyn, of lawful age, declares and says as follows:

1. My name is Lee L. Selwyn; I am President of Economics and Technology, Inc. ("ETI"), Two Center Plaza, Suite 400, Boston, Massachusetts 02108. I submitted a Declaration in this matter on June 30, 2003, on behalf of AT&T Corp. ("AT&T").

2. In this Reply Declaration, I respond to the Comments and accompanying Declaration submitted by Verizon, SBC, and Qwest, and the Comments of BellSouth in this proceeding. The BOCs contend, generally, that dominant carrier regulation is unwarranted, unnecessary, and

unduly burdensome. Each relies upon the long distance market share then held by AT&T at the time that the Commission had determined AT&T to be non-dominant. Although generally ignoring their own local monopoly, the BOCs claim that competition, price caps, and economic theory prevent a BOC from engaging in cost-shifting or predatory pricing behavior. As I shall demonstrate herein, the BOCs' attempt to draw an analogy between the market and service conditions being confronted by AT&T at the time it was determined to be non-dominant and those applicable to the BOCs' long distance businesses today is inapposite, and their various other claims are without merit.

Summary

3. As I will discuss below, the BOCs' continuing dominance and control of the local bottleneck affords them both the incentive and the ability to engage in anticompetitive conduct, including predatory pricing and discrimination, and unless constrained by affirmative regulatory oversight will ultimately and inevitably result in BOC remonopolization of the long distance market. The static condition of AT&T's market share at the time that the Commission had found AT&T to be non-dominant was only one of the attributes of AT&T that led to the Commission's determination. Unlike the BOCs today, in 1995 AT&T controlled no bottleneck facilities. AT&T had no ability to raise its rivals' costs. AT&T was not a dominant local exchange carrier — indeed, AT&T was not any *sort* of local exchange carrier. If the 1995 condition of AT&T is to serve as a basis for assessing the BOCs' dominance vs. non-dominance at the present time, then the BOCs must be prepared to accept and to adopt for themselves *all* of the substantive

attributes that characterized AT&T in 1995. They would need to accept permanent separation of their local and long distance operations. They would need to forego joint marketing and bundling of local and long distance services. They would need to accept balloting for diversification of local service shares. They would need to accept separate ownership of their long distance and local exchange service businesses. Those changes in the BOCs' status would create comparability between the AT&T of 1995 and the BOCs of 2003 and beyond. Short of that, there is no basis for or merit to the suggestion that the factors considered by the Commission when conferring non-dominant status upon AT&T have any relevance to the appropriate policy for the BOCs.

4. The analysis of the BOCs and their declarants is based upon selective considerations of markets — including complete disregard for the market definitions traditionally used by this Commission and suggested by the FNPRM. The BOCs intermittently ignore and minimize both their local and long distance market share and market share growth in an attempt to distract the Commission from the *fact* that the BOCs are amassing in-region residential market shares of more than 60% after only a few years in the business. The BOCs and their declarants disguise such market share figures in aggregate business and consumer shares, or in nationwide shares that are intended to conceal their formidable in-region, in-footprint concentration. Through the selective citing of analyst reports coupled with the convenient omission of the BOCs' own reported results and projections, the BOCs have here attempted to mislead the Commission as to the actual and projected state of long distance competition both currently and in the not-too-distant future.

5. That the BOCs have acquired these overwhelming long distance market shares is a direct result of their dominance in the local market. Through various accounting sleights-of-hand, the BOCs have the ability to shift the burden of marketing, customer acquisition and other costs to their captive local customers, and to ignore access costs that competing stand-alone IXCs must pay, thus creating the ingredients for imposing a price squeeze upon nonaffiliated rivals and, more generally, for pervasive predatory pricing. The BOCs' and their declarants assert the oft-repeated claim that "predation is rarely a profitable strategy." That view, however, is rooted in the patently incorrect *assumption* that the BOCs would be unable to recover their current losses from predation through higher rates in the future, because were they to attempt to raise prices once rivals exited the market, the rivals would immediately reenter and push BOC prices down. This theory would require, at a minimum, (a) that rivals would immediately reenter the market (after having exited it) as soon as the BOCs attempted to increase prices in the future, thereby foreclosing post-predation profit recoupment, or (b) that the BOCs have no ability to *cross-subsidize* current predatory pricing initiatives with excess profits generated by other BOC services. In reality, of course, *neither one of these prerequisite conditions exists*. There is almost no likelihood that investment capital would be made available to finance any consequential IXC reentry initiative, particularly in light of the enormous customer acquisition costs that any reentry attempt would necessarily face together with the threat of a repetition of a BOC predation strategy following such reentry. Indeed, this is precisely the sort of game theory perspective that Prof. Carlton and his Chicago School colleagues overlook when claiming that successful predation would be impossible. Moreover, by limiting their focus to the seemingly abundant interexchange network capacity that presently exists, Carlton *et al* ignore the much

larger component of reentry costs — the *reacquisition of customers who will have switched to the BOC* for their long distance service and the continuing obstacles that an IXC that is not also offering local exchange service would face when competing with BOC bundled local/long distance packages.

6. The BOCs rely upon the presence of price cap regulation as ostensibly precluding the opportunity for cross-subsidization of competitive services by excessive monopoly service rate levels, but that presupposes (a) that the price adjustment mechanisms in state and FCC price cap plans have been correctly specified, and (b) that once placed in operation, the price cap schemes are cast in stone and are never reviewed or revised based upon actual performance. Neither of these assumptions are correct. Ultimately, the tools of dominant carrier regulation would do nothing to remove the *incentive* of the BOCs to shift costs between regulated and unregulated entities, nor the incentive to drive competitors out of the market. Access charge reform and meaningful and nationally available facilities-based local competition are the only way such incentive would be minimized. What dominant carrier regulation would provide is the tools necessary for the Commission and other interested parties to evaluate a BOCs' allocation of costs between local and long distance services, and to compare these allocated costs to specific long distance and bundled local and long distance prices so as to determine that BOCs are pricing these competitive services in excess of cost. Without granular, service-by-service cost allocation, the Commission will have no way of enforcing Section 272(e)(3) or of ensuring that the BOCs are not engaging in a sustained price-squeeze.

The analogy that the BOCs seek to draw as between their existing long distance market share and that of AT&T in 1995 when it was declared non-dominant is superficial and inapposite.

7. SBC, Qwest, BellSouth and Verizon all seek to draw an analogy between their current share of the long distance market and that controlled by AT&T back in 1995, when the Commission reclassified AT&T as a *non-dominant* long distance carrier.[1] As they see it, the BOCs today have a smaller share of the long distance market than AT&T held at the time that it was classified as non-dominant, so on that basis the BOCs should now be declared non-dominant with respect to long distance services following the sunset of the Section 272(a) separate affiliate requirement. The Commission should not be misled into accepting this utterly superficial comparison as a basis for the policy determination at issue in this rulemaking proceeding.

8. There are, in fact, a number of fundamental differences between the market conditions facing AT&T back in 1995 and those applicable to the BOCs' long distance businesses today and in the not-too-distance future:

- AT&T was not in 1995 and is not today a dominant carrier in the *local exchange service* market. AT&T is required to pay cash out-of-pocket to originate and terminate all long distance calls that it carries from and/or to ILEC customers. BOCs, by contrast, at best make non-cash transfer payments *to themselves* for *all* originating access charges

1. SBC Comments, at para. 9 *et sec;* BellSouth Comments, at 3; Verizon Comments, at 21-26; Qwest Comments at 9, 13-14, 19.

and for a substantial portion — perhaps in excess of 50% — of terminating access charges associated with long distance calls provided by BOC long distance affiliates to BOC customers. In the case of *intraLATA* calls handled by the BOC, as well as inter-LATA calls handled by the BOC following sunset of the Section 272 separate affiliate requirement, the BOC does not even make an internal transfer payment accounting entry for the access services it utilizes. As long as access services continue to be priced at large multiples of forward-looking economic cost, the BOCs have both the incentive and the ability to create a price squeeze for their nonaffiliated rivals, something that AT&T could not have done once the BOCs were separated from it in 1984.

- In 1995, AT&T had no presence in the local exchange market; even today, AT&T provides local exchange service at retail to a tiny fraction of all residential customers, and serves these customers primarily via UNE-P arrangements leased from ILECs. In 1995, AT&T had no ability to bundle local and long distance services into a single service and pricing package; even today, without a consequential local service customer base together with often high UNE rates and the persistent above-cost access charges and other economic entry barriers imposed by the BOCs, AT&T's ability as an economic matter to offer such bundles ubiquitously is limited. Moreover, even that ability is threatened to the extent that UNE-P ceases to be available or ceases to be an economically viable service platform for such purposes.[2]

2. As I shall discuss at greater length at para. 26 *infra*, bundled offers pose significant risk (continued...)

- The rapid decrease in AT&T's long distance market share following implementation of interLATA equal access can be attributed, in large part, to several *affirmative* FCC policy initiatives aimed specifically at bootstrapping rapid OCC growth. Prior to the availability of 1+ presubscription (equal access) in any central office, competing IXCs were offered access services at deep discounts, in excess of 55%, relative to the prices that AT&T was required to pay ILECs for access services. Following the implementation of equal access in any central office, customers (for whom AT&T had, up to then, been the default long distance carrier) were sent "ballots" through which they were given the opportunity to affirmatively select a long distance carrier, AT&T or otherwise. And for those customers who did not respond to their "ballot," a long distance carrier was selected for them on a random assignment basis, in proportion to the affirmative carrier choices made by those responding to the balloting process. In stark

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2. (...continued)
for CLECs. In addition, the BOCs' efforts to eliminate UNE-P as an economic choice for CLECs and IXCs has intensified in recent months. In early May, SBC succeeded in getting legislation passed in Illinois *in just four days following its introduction in the Illinois General Assembly* that directed the Illinois Commerce Commission to issue an Order roughly doubling UNE-P rate levels. Illinois Public Utilities Act 13-408, 13-409 enacted May 9, 2003. On June 9, 2003, Federal District Court Judge Charles P. Kocoras issued a Preliminary Injunction staying the Illinois Commission's Order. *Voices for Choices et. al. v. Illinois Bell Telephone Co. et. al.* Before the United States District Court, Northern District of Illinois, Eastern Division, Docket No. 03 C 3290, *Memorandum Opinion*, June 9, 2003. On July 1, 2003, Verizon filed a *Petition for Expedited Forbearance* asking the FCC to forbear from requiring that UNE-P rates be based upon TELRIC and further to require that the BOC, rather than the CLEC utilizing the UNE-P arrangement, be the recipient of all access charge revenue associated with the UNE-P service. *Petition for Forbearance From the Current Pricing Rules for Unbundled Network Element Platform*, WC Docket 03-157, Petition for Expedited Forbearance of the Verizon Telephone Companies, filed July 3, 2003.

contrast, BOCs were *never* subjected to any sort of balloting as a condition for opening up the local market to competition, and rather than being offered *discounted* rates for unbundled access to BOC local networks, local service entrants have been subjected to UNE rates that often exceeded the BOCs' retail local service prices.[3]

- As of 1995, AT&T's share of the interLATA long distance market had been steadily declining since the 1984 break-up of the former Bell System, and that downward trend was expected to continue. The transition to "equal access" began in about 1985 and was substantially completed by about 1989. Between 1985 and 1995, AT&T's share dropped from 86.3% to 51.8%.[4] Since 1995, it has decreased to the point where in 2001 AT&T controlled only about 37.4% of the interLATA market.[5] In stark contrast, the BOCs' shares are growing — and growing rapidly — in the wake of their receipt of Section 271 in-region interLATA authority. In fact, in each of the states in which BOC long distance entry had occurred, the BOC had succeeded in capturing more market share in just 24 months than all of the non-AT&T interexchange carriers — the so-

3. See, e.g. Billy Jack Greg, West Virginia Consumer Advocate Division, *A Survey of Unbundled Network Element Prices in the United States*, January 2003, at Table 3. (available at: http://www.cad.state.wv.us/103Matrix3.pdf)

4. FCC, IATD, *Statistics of the Long Distance Telecommunications Industry*, May 2003, ("*Long Distance Market Share Report*"), at Table 7. Percentages measured on the basis of revenues.

5. *Id.*

called "Other Common Carriers" ("OCCs") — combined had been able to take from AT&T after *ten years* following the full implementation of equal access.[6]

- In 1995, AT&T had no significant presence in the *intraLATA* toll market at all, and had no presubscribed customers for intraLATA toll service. Although intraLATA equal access is now universally available and has been available generally since about 1999, in regions where the BOC has in-region interLATA authority BOCs and their long distance affiliates often control in excess of 40% of the intraLATA toll market[7] — and that share is likely to grow as the BOCs and their long distance affiliates gain inter-LATA market share, and therefore reclaim customers who switched their intraLATA PIC from the BOC to their interLATA provider.

For all of these reasons, the suggestion by the BOCs and by their consultants that, on a basis of a static market share "snapshot" their existing market power in the long distance market can be compared with that available to AT&T in 1995 is nothing short of ludicrous.

9. In theory, Section 272 attempted to simulate for the BOCs' long distance affiliates the separate and BOC-dependent situation of the IXCs. As discussed in my June 30 Declaration, the

6. *Id*. From 1989-1999, AT&T lost 27% market share. As noted in para. 21 *infra*, BOC affiliates are able to gain 30% market share in only twelve months.

7. *Id.,* at Table 16. For example, Verizon has 46.7% intraLATA market share (based on minutes) in the Mid-Atlantic region, and SBC has 41.4% intraLATA market share in Nevada and California.

structural separation requirements of Section 272, had they been implemented as envisioned by this Commission (which they were not, as discussed in my June 30, 2003 Declaration, at paras. 61-70), should have forced the BOCs' long distance affiliates to stand in the same lines and face the same costs as competing IXCs. As the Commission has noted in this FNPRM, it was precisely the presence of these *structural* requirements of Section 272 upon which the Commission had based its prior decision that the BOC affiliates could be classified as non-dominant during their initial three years.[8] However, for the period after those *structural requirements* sunset, the BOCs are now relying upon the Commission's 1995 decision to classify AT&T as non-dominant, arguing that the market conditions extant at that time for AT&T are the same as those confronting the BOCs today. In advancing such contentions, the BOCs ignore the fact that AT&T was, in 1995, subject to far more stringent structural separation requirements than those applicable to the BOCs and their long distance affiliates under Section 272. AT&T had been completely divested from the BOCs, *and controlled no network elements or other resources* that its long distance rivals required in order to provide competing services. Despite this glaring difference, the BOCs seek to draw an analogy from the Commission's market power finding with respect to a *divested* AT&T to a current snapshot of long distance market share held by *integrated* monopoly local carriers. That analogy cannot withstand scrutiny.

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8. *Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements*, WC Docket No. 02-112, *2000 Biennial Regulatory Review Separate Affiliate Requirements of Section 64.1903 of the Commission's Rules*, CC Docket No. 00-175, *Further Notice of Proposed Rulemaking*, May 19, 2003 ("*FNPRM*"), citing *Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area,* 12 FCC Rcd 15756, 15806 (1997) ("*LEC Classification Order*").

10. The structural separation requirements of Section 272, unlike the Bell System break-up, did nothing to mitigate the BOCs' market power in the local market *within their individual local service footprints*. The BOC long distance reentry provisions of Section 271 were premised upon the expectation that if the local markets were *opened* to competition, the BOCs would be unable to exert market power in long distance. However, Section 271 does not condition long distance entry upon any showing that BOC market power has actually been diminished. Attenuation of BOC market power can only come from successful *facilities-based* competitors in the local market that are not forced to rely upon BOC essential inputs to provide services.

The failure of local competition to develop during the three year time period of Section 272 ensures that the BOCs will now be allowed to provide integrated local and long distance service while maintaining control of the local bottleneck.

11. Significantly, but not surprisingly, the irrefutable *fact* (as I discussed at paras 9-22 of my June 30, 2003 Declaration) of persistent BOC dominance and control of the local market was conveniently and completely ignored by BOC Declarants Carlton, Sider and Shampine ("Carlton *et al*"), who limit their "analysis" solely to the superficial comparison of AT&T's *stand-alone* long distance share in 1995 with a distorted projection of BOC *integrated* local/long distance share as of 2005.

12. The local service market is anything but universally addressable by competing CLECs and IXCs. As I noted in my June 30, 2003 Declaration, the latest FCC *Local Competition Report* for end-of-year 2002 puts the ILEC share of access lines, including resale and UNE services

provided to CLECs, at 96.6%.[9] Some three-quarters of *all* CLEC lines utilize underlying services and facilities obtained from ILECs. That 96.6% figure is undoubtedly even higher for CLEC mass market residential and small business customers, and actually understates total ILEC facilities-based share by erroneously treating CLEC services utilizing BOC special access as "facilities-based."

13. SBC and Profs. Carlton *et al* repeatedly cite a study by Deutsche Bank to support their market share positions.[10] These citations, as it turns out, are highly selective. Specifically, in terms of the local market, the Deutsche Bank study notes the ILECs' control of bottleneck facilities, and their ability to leverage this control to disadvantage IXCs:

> If we leave aside the issue of capital expenditure where there is clearly a large degree of latitude, the ILECs exert a de-facto monopoly provision of local access, local termination and local private lines. This means that the IXCs have very little control over the cost of originating and terminating their voice and data products.[11]

9. Selwyn June 30, 2003 Declaration, at para. 11, citing FCC Wireline Competition Bureau, Industry Analysis and Technology Division, *Local Telephone Competition: Status as of December 31, 2002*, Rel. June 12, 2003, ("*Local Competition Report*") at Tables 3&4. Calculation was made using the ILEC total lines from Table 4 (which includes ILEC end user lines, resold lines and UNEs) divided by the sum of ILEC total lines and CLEC-owned lines (from Table 3).

10. SBC Comments, at 27. Carlton *et al*, at fn. 19-20, paras. 27, 43, Table 1, citing Deutsche Bank Industry Update, Wireline - Mid Year Review, May 27, 2003, ("*Deutsche Bank Study*").

11. Deutsche Bank Study, at 68.

14. Although Verizon attempts to claim there has been "tremendous growth in both local and access competition over the past six years,"[12] it ignores the finding of Deutsche Bank that this growth is likely to end soon, and perhaps even reverse.

> We continue to believe that through changes to the TELRIC calculation and repricing of elements, we should see a gradual rise in UNE-P tariffs, while by the time UNE penetrates around 15-20% of lines, the re-seller model should start running-out of steam. We therefore continue to believe that the eye of the storm has passed, with a declining rate of unbundling though the balance of 2003 and 2004, and some possible win-backs in 2005-2006.[13]

15. With regard to cable telephony, Merrill Lynch and Deutsche Bank both note that it does not pose any immediate threat to the BOCs' local market share. Hence, this potential source of facilities-based competition will have no consequential effect in constraining BOC use of their local bottleneck to benefit their long distance services:

> Cable telephony remains a substantial long term challenge for the RBOCs in our view. However, given the recent investor concerns over the balance sheet of many cable companies, cable telephony competition could be muted near-term if cable companies direct their efforts to their basic video offerings conserving capex and boosting cash flow. *We estimate that cable telephony*

12. Verizon Comments, at 16.

13. Deutsche Bank Study, at 23. Deutsche Bank raises the possibility that VoIP may someday be competitive with ILEC dial tone services, but even so does not expect that VoIP will enable competitors to compete on equal footing with the BOCs.

> *already serves nearly 2% of residential lines, yet only 10% to 15% of homes in the US are cable telephony ready*.[14]

Considering the uncertainty of facilities based competition, and the severe limits of resale and UNE based competition, the BOC control of the local bottleneck remains secure for the foreseeable future.

16. BOC local market power is confirmed by several recent Verizon's pricing moves. Verizon has recently asked for (and received) local price *increases* in New York and Massachusetts,[15] and has made similar proposals in several other states.[16] Indeed, despite the reductions in Verizon's intrastate access charges in Massachusetts that accompanied these local monthly rate increases, Verizon has just *increased* its Massachusetts intraLATA toll rates by *more than 30%*![17] Were Verizon truly facing price-disciplining local competition, it is unlikely that it would *or could* unilaterally raise these prices without driving away customers —

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14. Merrill Lynch, *BellSouth Corp.,* January 27, 2003, at 4.

15. Verizon Press Release, *New York PSC Approves Verizon Regulatory Plan, Company Announces First Basic Rate Increase in 11 Years,* February 27, 2002. Verizon Residential Billing Insert, "Verizon Extra," June 2003.

16. "Verizon Wants to Raise Local Rates," *The Standard-Times*, June 7, 2002, at A10; "Verizon to Change Various Telephone Rates Under Price Cap Filing," Missouri PSC Press Release, available at http://www.psc.state.mo.us/press/pr0177.pdf.

17. Verizon Extra Billing Insert, Massachusetts Residence, July 2003.

especially in New York and Massachusetts, states with some of the highest (although still small) CLEC penetration rates in the nation.[18]

BOC claims of low long distance market share figures are patently false and misleading, even according to their own data, and the Commission must focus upon the 60%-70% residential market share that BOCs have achieved and are likely to achieve in mature long distance markets.

17. Discussions of "the long distance market" that the BOCs and Carlton *et al* present ignore the completely distinct mass market (residential, small business) and enterprise (large business) segments. The Commission has repeatedly found that the mass market and enterprise segments to be separate markets with separate and distinct competitive attributes.[19] The market share figures cited by the BOCs and by Carlton *et al*, and indeed all of the BOCs' discussions of "the long distance market," ignore the Commission's determination that "[i]n this proceeding, we initially consider two broad customer classes: the mass market and the enterprise market." Moreover, by stating BOC long distance shares as percentages of the *national* long distance market, the BOCs distort and understate the practical effect of their extraordinarily successful and rapid ramp-up of long distance shares *within their respective Section 271 states or in other*

18. FCC, IATD, *Local Telephone Competition: Status as of December 31, 2002,* June 2003, at Table 7.

19. See, e.g. *In the Matter of Local Competition and Broadband Reporting*, CC Docket 99-301, Rel. March 30, 2000, 15 FCC Rcd 7717, 7754; *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, CC Docket 98-98, Third Report and Order and Fourth Further Notice Of Proposed Rulemaking, Rel. November 5, 1999, 15 FCC Rcd 3696, 3829.

non-BOC operating areas[20] *in which no Section 271 authority was required*. SBC has projected, and FCC data confirm, that a BOC residential share in the range of 60% in each of its ILEC jurisdictions is entirely realistic.

18. Carlton *et al*, as well as their clients, persist in ignoring these distinctions, and continually quote and point to aggregate long distance market share figures such as those presented in Figure 1 of the Carlton *et al* Declaration. Carlton *et al* cite the Deutsche Bank study for the proposition that the BOC share of the (aggregate) long distance market will level off at approximately 27%.[21] They conveniently omit any reference to the Deutsche Bank study's conclusions specifically with respect to the *residential* segment:

> We are unlikely to win the Nobel Prize for Economics by claiming that the IXCs will lose market share to the benefit of the RBOCs, particularly if the extremely competitive monthly plans currently in the market become a fixture. This is demonstrated by a study recently conducted by TNS Telecoms, which shows that the RBOCs as a group have increased their share of residential interLATA minutes by 590 bps [basis points] to 10.6% in the past two years alone. When we consider that the majority of s271 clearances were completed over the past six months, then it is clear that the trend can only get worse for the incumbent IXC's. Of course, if we were to wrap in intra-LATA toll (a.k.a. local toll) where the RBOCs have had no restrictions, then their market share of residential would be even higher.

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20. The specific "Bell Operating Companies" to which satisfaction of the Section 271(c)(2)(B) "competitive checklist" applies are identified at 47 U.S.C. §153(4). SBC's Connecticut subsidiary, SNET, and all of the former GTE companies outside of Pennsylvania and Virginia that were merged with Bell Atlantic to form Verizon, are not "Bell Operating Companies" as defined in the statute.

21. Carlton *et al*, at Figure 1.

> Therefore AT&T which has seen its slice of the residential interLATA toll volumes fall from 44.7% to 31.2% in the space of just two years, is facing the twin peril of a declining share of a market which is in itself diminishing. We estimated that the RBOCs will very quickly gain traction in signing up long distance customers, as early progress reports from new market entry over the past 12 months appears to suggest (SBC claimed 12% of the Californian residential market in its first four months of operation).
>
> *We estimate that RBOC long-distance lines (inc. Qwest) grow from 17.5 million at the end of 2002, to 30 million at the end of 2003, to 40 million by end-2004, and 48-49 million longer-term.* This corresponds to a LD penetration rate of around 40% longer term, across its retail access line base — over 50% in terms of the consumer access base — and 27-28% of total long distance lines in the US.[22]

Similarly, Deutsche Bank notes that "[c]learly their [the BOCs'] share of the consumer toll market will be much larger (closer to 50%), with the total brought down by a weaker presence in the corporate and wholesale segments."[23] By selectively noting the Deutsche Bank national market projections together with SBC claims regarding residential long distance share in Texas, Profs. Carlton *et al* imply that BOC residential market shares will remain relatively low in "the long distance market." The BOCs, always quick to point out the "conservative" nature of their estimates of *local* competition, in this instance failed to note that Deutsche Bank had characterized its expectations of steady state *long distance* market shares — including the over 50% consumer long distance market share — as being "on the conservative side."[24]

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22. Deutsche Bank Study, at 84, emphasis in original.

23. Deutsche Bank Study, at 87.

24. Deutsche Bank Study, at 99.

19. If there is any doubt of the critical role that *local* market power plays in allowing a BOC to capture residential *long distance* share, one need only look to SBC's share of the long distance market in Connecticut, where its SNET affiliate is the dominant local exchange carrier *and* because SNET was never subject to Section 271, has been offering its local service customers long distance service longer than any other large ILEC. The FCC's *Long Distance Competition Report* for 2002 gives SBC's residential long distance market share for the seven Northeast states[25] at 6.7%. However, as I mentioned in my June 30 Declaration, SBC will only provide long distance service to SBC local customers.[26] Since SBC has no consequential local service presence in any of the Northeast states *other than in Connecticut*, it is reasonable to assume that SBC's residential long distance household share *outside of Connecticut* is zero. SNET's Connecticut operating territory represents approximately 9.8% of all residential access lines in the seven Northeast states, indicating an SBC/SNET long distance share of approximately 6.7%/ 9.8%, or 68% overall.[27] This estimate exceeds the claim made by SBC in January, 2003 that it

25. The Northeast states include Maine, New Hampshire, Vermont, Massachusetts, Rhode Island, Connecticut, and New York. Long Distance Market Share Report, at Notes to Tables 15-17.

26. Selwyn June 30, 2003 Declaration, at para. 66.

27. Residential access lines were estimated by multiplying the total end user switched access lines served by local exchange carriers by the percentage of lines provided to residential and small business customers for each respective Northeast state. *Local Competition Report* at Tables 6 and 11. SNET Connecticut 2002 residential access lines from ARMIS Report 43-08, Table III, for year end 2002. Households with multiple lines were assumed to have the same long distance carrier for each line.

has acquired a 60% market share in Connecticut.[28] A similar calculation can be made for Verizon's former GTE service areas in California and Nevada. Although Verizon does not limit its long distance service to its own local customers, Verizon does not market its stand-alone long distance plans to other than its own local customers. It is therefore likely that the vast majority of Verizon long distance customers in California and Nevada are also Verizon local customers. A similar estimate based upon the *Long Distance Market Share Report* for Verizon' California/ Nevada local service customers suggests that Verizon has also achieved a 68% long distance market share within its California/Nevada local service footprint.[29]

20. Despite these facts, SBC makes the incredible claim that "[t]hough BOC long distance business has been increasing, no one forecasts it will ever hit the roughly 60% level that AT&T had when it was declared to be non-dominant."[30] However, as I noted in my June 30 Declaration, SBC management expressly and specifically stated that *based upon its actual*

28. SBC Investor Briefing analyst conference call, January 28, 2003.

29. Residential access lines were estimated by multiplying the total end user switched access lines served by local exchange carriers by the percentage of lines provided to residential and small business customers for California and Nevada. *Local Competition Report* at Tables 6 and 11. Total Residential Lines estimated at 20.156-million. Verizon California and Verizon Northwest California and Nevada residential access lines from ARMIS Report 43-08, Table III, for year end 2002 (3.164-million). GTE lines account for 15.7% of residential lines in California and Nevada. 15.7%/10.7% results in 68.2% long distance share. Households with multiple lines were assumed to have the same long distance carrier for each line.

30. SBC Comments, at 25.

experience in Connecticut, the Company expected ultimately to realize a market share of approximately 60% in all of its Section 271 states.[31]

21. In addition, based upon its conversations with SBC executives, Bear Stearns notes that "SBC assumes that it can achieve 30% [consumer] market share 12 months after entering a new market and is targeting long run (3-4 years) penetration rate in the 60%-70% range."[32] Obviously, SBC's statement to the Commission that "no one" has made such a forecast is more than merely disingenuous, it is an out-and-out falsehood.

The BOCs control of the local bottleneck gives them monopoly market power with respect to bundled local/long distance service packages.

22. Deutsche Bank notes that the ability to provide bundled services is a "key competitive advantage in the telecom industry."[33] Despite its immense importance, however, Carlton *et al* *completely ignore the existence of local/long distance service bundles* when discussing the future of the long distance market. Drs. Carlton *et al* cite the importance of wireless, VoIP, even e-mail as reasons for the declining total revenues of the long distance market, but completely fail to

31. Selwyn June 30 Declaration, at para. 37, citing Statement of Edward Whitacre, CEO, SBC Communications, Transcript, April 24, 2003, SBC Conference Call Addressing First Quarter 2003 Earnings.

32. Bear Stearns Equity Research, *SBC Communications Inc. (SBC-24.88) – Outperform*, September 10, 2002.

33. Deutsche Bank Study, at 54.

note that part of that decline is a direct consequence of BOC offerings of bundled local and long distance services. Carlton *et al* acknowledge the decline in stand-alone long distance minutes and thus long distance revenues, but ignore the role played by the BOCs themselves in cementing this fundamental market change in the wireline market. As noted by Deutsche Bank,

> ... RBOCs are commoditizing long distance within the consumer bundle, resulting in significant pressure on revenue yields and rapidly reducing the overall size of the long-distance switched market. ... we estimate that a market worth $87bn in 2001 has already declined to $66bn in 2002, and is likely to fall towards $40bn by the end of the decade. Indeed, the position might be even worse, as indicated by some of the recent RBOC pricing trends, with long-distance included as part of the overall bundle for as little as $5 per month.[34]

23. Beginning with the break-up of the former Bell System in 1984, telecommunications pricing and purchasing has been separated as between local and long distance services. The BOCs' long distance entry is fundamentally altering this paradigm. By offering "unlimited" long distance calling at an almost negligible pricing increment vis-a-vis local service — a pricing incremental that frequently falls short of the out-of-pocket access charges that a rival IXC would be forced to pay to provide a comparable quantity of long distance calling — the BOCs are fundamentally reshaping mass market telephone service into what some have called an "all distance" model in which carriers that offer "less than all" of the components of such "all distance" packages will be relegated to the lowest end of the customer spectrum. And by exploiting their captive, near-ubiquitous local service customer base, the BOCs are able to

34. Deutsche Bank Study, at 34.

extend their local market dominance into long distance and make a large portion of residential customers enormously more difficult to address, as a practical matter, by carriers that do not have the local service incumbency advantages uniquely available to BOCs.

24. Indeed, the BOCs' ability to engage in this service bundling strategy arises directly from several critically important competitive advantages that have been expressly conferred upon them by Congressional and FCC public policy initiatives:

(a) BOCs are able to set and maintain access charges at large multiples of forward-looking incremental cost.

(b) When BOCs provide long distance service on an integrated basis with local, they do not purchase access services from themselves and do not "pay" themselves access charges. Even though the Section 271 separate affiliate is required to purchase access services and pay the ILEC entity for them, such payments are intracorporate transfers that have no effect upon the corporate "bottom line" and can be — and are — regularly ignored by the BOC when setting retail prices. Imputation rules that are supposed to foreclose such conduct are largely ineffective in preventing the BOC from imposing a price squeeze on nonaffiliated IXCs.

(c) BOCs are afforded unique and preemptive access to their legacy base of local exchange service customers, and are expressly permitted to engage in joint marketing of local and long distance services, resulting in the BOCs' incurring only a small fraction of the customer acquisition costs that nonaffiliated IXCs confront.

25. To transition a BOC's local customer to a BOC bundle that includes long distance, all that is needed is for the BOC to add to the incremental cost of providing long distance service, minus above cost access, to the price it already sells to local customers. Such a process is completely seamless to the consumer and without risk to the BOC. A nonaffiliated carrier seeking to compete with a BOC for such "bundled" service packages must be prepared to offer local service at retail, either by deploying its own facilities or by means of BOC-provided resale services or UNEs.

26. Deutsche Bank recognized that competitors face significantly higher risks in the bundled market than are faced by BOCs:

> Although the bundling strategy is fraught with uncertainties for the RBOCs, the degree of uncertainty facing long-distance (UNE-P) carriers is of a significantly higher order of magnitude. Essentially, what operators like AT&T and MCI are trying to achieve is the "synthetic" or "virtual" RBOC formulae, relying on a mix of UNE-P, UNE-L, re-sale, marketing arrangements with cable operators, etc. to access the customer base. These "virtual RBOCs" rely on a mix of low wholesale access prices, their name and reputation in the long-distance market, and the ability to remain flexible and technology-agnostic in selling bundles to customers.

> Clearly, the whole formula relies on the continuation of the current wholesale discounts, and the ability to maintain a flexible cost structure. Any significant change in the regulatory climate will completely negate this model, as would any significant change in external costs (such as marketing, revenue sharing, etc). At the end of the day, very few re-seller models survived and succeeded anywhere globally, and for good reason. Virtual companies have limited control over their cost structures and ability to enhance quality of service, and indeed do anything else other than discount prices.[35]

Indeed, in the long run, Deutsche Bank dismisses the ability of a UNE provider to compete with a BOC's bundled offerings:

> The real problem is not one of legalistic interpretations of Congress's intentions in the drafting of the Telecom Act, but rather that there are glass ceilings to the resale model. We believe that these limits are reached when around 25-30% of residential customers have gone into a wholesale relation-ship. Following this point, consumer apathy combined with a relatively high rate of churn (RBOC win-back programs) should limit further market share gains for the unbundlers. This means that meaningful residential local line share gains should be possible over the next 7-8 quarters, but are estimated to peak at 6.5 million longer term.
>
> *However 6.5 million local lines is not sufficient to anchor a business that encompasses an estimated 40-45 million pre-subscribed toll customers, that are wide open to RBOC attack.* While it could be argued that the RBOCs are acting as resellers in this space (as they purchase wholesale toll capacity from facilities-based IXC's such as AT&T), the reality is that toll is a much smaller share of the pie than the local exchange portion. The average residential spend on local exchange services is $36-37 per month, compared to $12-13 for long distance services. Therefore the RBOCs have the incentive to completely commoditize the long distance value proposition in the interests of defending their higher value local exchange franchise. This is the method in the madness of the extremely competitive RBOC packages in the market, offering inter-

35. Deutsche Bank Study, at 36.

LATA for as little as $0.02 per minute vs. prevailing rates for around $0.07-0.09.[36]

The requirements of this "bundled" marketplace, including the reliance of CLEC bundles providers on RBOC local facilities (especially the continued existence of UNE-P and its treatment of access charges), result in unique risks for IXCs and other possible entrants in the market. Bundled services should be considered by this Commission as a market separate from either the local *or* the long distance market. These services present specific cost allocation problems well addressed by the granular and service specific cost support data required by dominant regulation.

Verizon claims that the BOCs have not leveraged their bottleneck power in the intraLATA, interLATA corridor, information services, CPE, and wireless markets do not provide probative evidence contradicting the trend toward BOC remonopolization of the long distance market.

27. Verizon's attempt to link the Commission's previously successful efforts at introducing competition into BOC bottleneck monopolies ignores important factors that render any such comparisons meaningless. Verizon cites examples of "comparable" markets where the BOCs claim to have lost significant market share, despite their ability to provide these services on an operationally integrated basis with their local offerings.

36. Deutsche Bank Study, at 100, emphasis in original.

InterLATA Corridor Traffic.

28. Under the terms of the MFJ, two "corridors" were established in the New York/New Jersey and Philadelphia/New Jersey metropolitan areas, respectively, within which the BOCs serving these areas (then Bell Atlantic and NYNEX, now Verizon) were permitted to carry inter-LATA traffic. However, upon implementation of interLATA equal access in the mid-1980s, *the so-called "corridor" traffic was subject to the same interLATA PIC as all other interLATA traffic*. Seeming to ignore this critically important fact, Verizon notes that Bell Atlantic's ability to provide interLATA corridor traffic on an operationally integrated basis with its local services did not do anything to help it to retain market share, which Verizon claims has by now dropped to insignificant levels.[37] However, in the case of "corridor" calling, customers were *never* afforded the ability or opportunity to specify a separate "corridor" PIC. Hence, unless the caller made a special effort to "dial around" her selected interLATA PIC by using a 101-XXXX access code to use BOC "corridor" service (which among other things would require that the customer accurately identify particular calls as falling within the "corridor"),[38] those calls would auto-matically be routed to the caller's interLATA PIC.

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37. Verizon Comments, at 13.

38. Except for the New York end of the New York/New Jersey "corridor," which consisted specifically of the five New York City boroughs that could be easily identified by the '212' and later the '212' and '718' area codes (thus potentially enabling northern New Jersey customers to determine that calls made to these area codes could be dialed as "corridor" calls), the northern New Jersey, Camden and Philadelphia portions of the corridors were *subsets* of the (then) '201', '609', and '215' area codes, respectively, making it extremely difficult for a customer dialing a "corridor" number to readily associate a given call to these NPAs as presenting a BOC "corridor service" option.

IntraLATA Toll.

29. Verizon claims that BOC provision of intraLATA toll operations have always been provided on an unseparated basis and yet notes that the BOCs have lost substantial intraLATA market share since intraLATA equal access was implemented nationwide around 1999. Verizon cites this loss of BOC market share as further evidence that the BOC has no ability or incentive to leverage bottleneck facilities to prevent competition.[39] The evidence shows otherwise.

30. Dialing parity does exist today with respect to intraLATA toll, and while competition is present, BOCs continue to dominate this segment. As discussed at considerable length in my August 5, 2002 Declaration in the Section 272 Sunset proceeding,[40] intraLATA toll/local integration permits the BOCs to provide end-to-end service *without utilizing switched access services* of the type that are provided to IXCs, and in so doing gain cost and operational advantages that have enabled BOCs to offer retail intraLATA services at or below access charge levels. In fact, Verizon witness Dr. Tardiff appears to concede this point in the Declaration cited by Verizon, where he notes that IXCs "had to compete against inexpensive local calling within the LATA"[41]

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39. Verizon Comments, at 13.

40. *Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements,* WC Docket No. 02-112, Declaration of Lee L. Selwyn, filed August 5, 2002, at paras. 58-59.

41. *In the Matter of Petition for Forbearance From The Prohibition of Sharing Operating, Installation, and Maintenance Functions Under Section 53.203(a)(2) Of The Commission's Rules*, CC Docket No 96-149, Declaration of Timothy J. Tardiff attached to Reply Comments of Verizon, filed Sept. 24, 2002, ("Tardiff Declaration") at para. 8. In New Jersey, for example,
(continued...)

Although IXCs have been successful in encouraging many customers to select the IXC for both intraLATA and interLATA service, the fact that (prior to receiving Section 271 authority) the BOCs continued to provide intraLATA toll to nearly half of all local service customers *even though 100% of those customers were required to affirmatively select a separate interLATA carrier* serves to underscore the enormous value of the BOCs' incumbency and operational integration.[42]

31. Significantly, BOC entry into the *interLATA* market appears to have reversed the downward trend the BOCs had been experiencing with respect to *intraLATA* market share. Verizon's

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41. (...continued)
Verizon customers can purchase "Selective Calling Service" affording up to eight (8) hours of flat-rate calling (and low per-minute rates for usage in excess of that level) to nearby exchanges that would otherwise be subject to toll charges. Rates for Selective Calling service may be as low as $5.83 for a 24 hour block-of-time to three nearby exchanges, amounting to as little as $0.004 per minute (Verizon New Jersey Inc, Tariff B.P.U.- N.J. No. 2, Exchange and Network Services, Sixth Revised page 21, effective June 18, 2001). Verizon's intraLATA switched access charges that an IXC would pay to provide an intraLATA call in New Jersey amount to $0.017868. Verizon New Jersey Inc. B.P.U. NJ Tariff No. 2, Exchange and Network Services, Sixth Revised Page 21, Effective June 18, 2001. Similar optional expanded local calling plans can be found in other states, including Massachusetts (New England Telephone and Telegraph Company, MADTE No. 10, Exchange and Network Services, Part A Section 10, effective July 14, 1999).

42. Dr. Tardiff put BOC intraLATA toll *revenue* shares at roughly 45%. Tardiff, at fn. 10. Since IXC shares include services furnished to customers over special access facilities leased from ILECs, the BOC share of the "dial-1" intraLATA toll market is undoubtedly well in excess of that 45% level. Additionally, the "toll" revenues cited by Tardiff *exclude* BOC revenues gained from optional expanded *local* services that themselves compete with IXC-provided intraLATA toll and that BOCs are able to provide at below-access-charge prices specifically because of their ability to integrate the access and interexchange functions.

3rd Quarter 2002 Report indicates that BOC interLATA authority is halting the effect of intra-LATA dialing parity on competition in the intraLATA market, reporting a net gain in intraLATA customers for each of the past five quarters.[43] More generally, since it is almost inconceivable that a customer would select a BOC for interLATA service while choosing a *non-BOC* carrier for intraLATA calling, the BOCs' share of the interLATA long distance market in "271" states represents a *lower bound* of the likely BOC intraLATA share. Thus, if the BOC interLATA share can be expected to reach the 60% range and assuming that roughly half of all customers who have selected a non-BOC IXC for interLATA calling *continue to select the BOC as their intraLATA PIC*, then the BOC intraLATA share could well increase back to a level of 80% or higher.

Information Services.

32. Verizon observes that while BOCs are permitted to offer "information services" on an integrated basis with no OI&M separation requirements, they nevertheless maintain only a small share of the information services market. For example, Verizon (again citing Dr. Tardiff) puts BOC (and GTE) shares of "voice mail" services at only 15% and notes that there are "hundreds of non-affiliated Internet service providers (ISPs)."[44]

43. *Verizon Investor Quarterly*, 3rd Quarter 2002, October 25, 2002 ("*Verizon 3Q Report*"), at 5.

44. Verizon Comments, at 14-15.

33. In claiming that BOCs maintain only a 15% share of voice mail revenues, it is likely that Dr. Tardiff had applied an unduly expansive market definition that includes segments that BOCs do not specifically target or even serve. With respect to voice mail, BOCs are primarily engaged in *retail*-level individual mailbox offerings targeted to BOC residential and single-line business customers. BOCs do not typically compete for voice mail business from purchasers of multiple mailboxes, such as PBX users. BOCs also do not typically compete for voice mail business from paging or CMRS carriers or from CLECs. The primary value of BOC operational integration with respect to voice mail lies in the single mailbox services provided to the residential and small business market, and BOCs appear to dominate this sector.[45]

34. Dr. Tardiff does, however, conveniently *ignore* one critically important aspect of BOC-provided ISP access — ADSL — in which BOCs are clearly exerting market power and leveraging their control of the local market into the adjacent competitive market for Internet access. In fact, BOCs have come to *dominate* the growing ADSL-based "high-speed Internet access" market.[46] The FCC last February announced details of the so-called *Triennial Review* order in which, among other things, the requirement that ILECs make the high-frequency

45. Verizon notes that its "bundles" services are driving penetration of "basic" vertical features such as Caller ID, and Voice Mail. According to Verizon, over 19% of consumer customers subscribe to a bundle. Many more are likely to subscribe to BOC voice mail separate from a bundle. Verizon 3Q Report, at 5.

46. As of December 31, 2002, the RBOC share of ADSL lines was 86.3%. As a percentage of high speed lines, the BOCs provided 32.2% of all high speed lines. FCC, IATD, *High Speed Services for Internet Access: Status as of December 31, 2002*, June 2003, at Table 5.

channel of a subscriber loop available on an unbundled basis for use in providing ADSL (so-called "line sharing") will be eliminated.[47] Although the text of that Order has not been issued as of the date of this Declaration, elimination of "line sharing" would for all intents and purposes make the ILEC the only source of ADSL service available to any of the ILEC's residential and small business customers. That dynamic has the potential to profoundly alter the nature of the information services market, and extrapolations from past experience cannot be used as a basis for projecting future conditions. If BOCs maintain their existing dominance of mass market local services and if they are also under no obligation to provide nonaffiliated ISPs with "open access" to their ADSL services, the BOCs would then have both the ability and the incentive to leverage their local service/ADSL monopoly into the adjacent Internet services market, and come to dominate that (now highly competitive) market as well.

Customer premises equipment (CPE) and inside wire.

35. At the time of the break-up of the former Bell System, the BOCs were forced to transfer their "embedded base" of customer premises equipment ("CPE") to AT&T and were required to provide new CPE through a separate affiliate. Without that embedded base of CPE as a foundation, the BOCs chose not to reenter the CPE market, and have still not done so even though, since 1996, the BOCs have been permitted to provide CPE on an integrated basis.

47. FCC, News Release, "FCC Adopts New Rules for Network Unbundling Obligations of Incumbent Local Phone Carriers," February 20, 2003.

36. In 1977 and 1978, the FCC adopted the Part 68 "equipment registration" program applicable to *all* CPE, whether provided by a BOC or other ILEC, or by the customer.[48] That action, together with the subsequent "unbundling" of the "primary instrument" from the basic dial tone line and the transfer of embedded CPE out of the BOCs, fundamentally and irreversibly changed the distribution channel for both consumer and business CPE. Rather than renting telephone sets and other station equipment as part of the process of ordering local telephone service, consumers were instead offered the ability to *purchase* this equipment outright through ordinary retail channels, such as Radio Shacks, K-Marts, and thousands of other retail outlets. CPE so purchased could then be plugged into the customer's telephone line in much the same way as electrical appliances were plugged into the customer's electric service. As a result, CPE was no longer limited to the familiar telephone handsets that were the mainstay of ILEC-provided equipment, and thousands of new consumer-oriented products have been introduced, *each one of which may be connected to the PSTN via the standard RJ-11 interface*. Business telephone systems — PBXs and the like — experienced a corresponding restructuring of distribution channels, with numerous new manufacturers and their retail dealers entering the market.

37. Put simply, the CPE "bottleneck" problem was solved by the simple adoption of the standard "RJ-11" plug and jack — and consumers and CPE providers don't even have to buy their RJ-11 jacks from the phone company, because the Commission had also deregulated

48. *Proposals for New or Revised Classes of Interstate and Foreign Message Toll Telephone Service (MTS) and Wide Area Telephone Service (WATS)*, Docket no. 19528, *Memorandum Opinion and Order*, Rel. June 20, 1977, 64 F.C.C.2d 1058; *Third Report and Order*, Rel. April 13, 1978, 67 F.C.C.2d 1255.

another CPE-related bottleneck — inside wire. Since CPE interconnection is now accomplished by a standard RJ-11 plug-and-jack and since these products are now being sold by retail channels ranging from local convenience stores to specialized consumer electronics dealers, there is no particular cost or competitive benefit that a BOC could derive from the OI&M and marketing integration that is now permitted for CPE, and indeed no such integration has actually occurred because the BOCs are not in the CPE business to begin with. Thus, contrary to Dr. Tardiff's "example," the fact that CPE may be provided and marketed by BOCs on an integrated basis with local telephone service teaches *nothing* about what the BOCs will be able to achieve with respect to long distance remonopolization should the OI&M restriction be lifted with respect to interLATA services.

38. Interestingly, ILECs *have* attempted to preserve their preexisting monopoly in the inside wire maintenance business by exploiting preexisting relationships with monopoly local service customers, such as in attempting to sell deregulated "inside wire maintenance services' on inbound contacts from local service customers. For example, the California PUC has received numerous complaints that Pacific Bell engages in exactly the type leverage of local market power the Verizon tries to deny. The California PUC required "the utilities to inform their customers that competitive alternatives may be available. This notification should be provided during customer calls to 611 repair services and when a repair employee is on the customer's premises and has identified a possible inside wire problem."[49] Complaints were

49. *In the Matter of the Application of Pacific Bell, a corporation, for authority to increase*
(continued...)

lodged with the CPUC by the Office of the Ratepayer Advocate and The Utility Reform Network that Pacific Bell violated this safeguard.[50] Other BOCs have been accused of engaging in "negative option" marketing of their "optional" inside wire maintenance services, leaving the monthly charge on the customer's bill as of the deregulation date until such time as the customer affirmatively asks that the "service" be discontinued.[51] These examples show that BOCs are willing to use their local service monopoly to benefit competitive service offerings.

49. (...continued)
certain intrastate rates and charges applicable to telephone services furnished within the State of California; And Related Matters, Before the California Public Utilities Commission, Decision No. 90-06-069, June 20, 1990, 36 CPUC 2d 609, 626.

50. *In the Matter of the Application of Pacific Bell (U 1001 C), a corporation, for Authority to Categorize Business Inside Wire Repair, Interexchange Carrier Directory Assistance, Operator Assistance Service and Inmate Call Control Service as Category III Service; In the Matter of the Application of Pacific Bell (U 1001 C), a corporation, For Authority to Categorize Residential Inside Wire Repair as a Category III Service*, Before the California Public Utilities Commission, CPUC Decision No. 99-09-036, September 2, 1999, 1999 Cal. PUC LEXIS 603, *18. This requirement was clarified in *The Utility Consumers' Action Network, Complainant, vs. Pacific Bell (U 1001 C), Defendant; And Related Matters*, Before the California Public Utilities Commission, CPUC Decision No. 01-09-058, September 20, 2001, 2001 Cal. PUC LEXIS 914, *57. The CPUC did not make any findings or conclusions about Pacific's compliance with these requirements, however, the decision directs Pacific Bell to disclose such information. *See The Utility Consumers' Action Network, Complainant, vs. Pacific Bell (U 1001 C), Defendant. And Related Matters*, Before the California Public Utilities Commission, CPUC Decision No. 02-02-027, February 7, 2002, 2002 Cal. PUC LEXIS 189, *34.

51. *See, e.g. Pennsylvania Public Utility Commission v. The Bell Telephone Company of Pennsylvania*, Docket No. 832316, Before the Pennsylvania Public Utilities Commission, Opinion and Order, Rel. April 16, 1984, 1984 Pa. PUC LEXIS 53.

Intermodal competition that relies upon services that are not yet mature, viable alternatives to wireline service and that themselves often require BOC and ILEC bottleneck facilities does not limit the BOCs' ability to dominate the long distance market once the separate affiliate requirement has been sunset.

39. Carlton *et al* contend that the presence of *intermodal* substitutes for wireline long distance calling works to limit BOC market power.[52] They posit that wireless services, e-mail, and VoIP (Voice-over-Internet Protocol) all need to be considered in assessing the extent of BOC dominance. Limited substitution among these services is clearly present, but the demand for wireline long distance services remains relatively inelastic.

40. A quantitative measure of the extent to which wireline long distance services confront intermodal competition is the *own price elasticity* of wireline long distance call demand, an issue that the Commission has grappled with in the past.[53] In at least two recent state PUC cases addressing rate reductions for BOC intraLATA toll services, the BOC offered highly inelastic price elasticity estimates, and challenged the less-price-inelastic estimates that were advanced by the commission staffs and by interveners.[54]

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52. Carlton *et al*, at paras. 26-44.

53. See, e.g., Policy and Rules Concerning Rates for Dominant Carriers, *Second Report and Order*, Docket No. 87-313, (FCC 90-314), para. 83 and 84 and Appendix C, released October 4, 1990.

54. Price elasticity can be defined as the percent change in quantity resulting from a 1% change in price. Since, for most "normal" goods and services, the price/quantity relationship is *inverse* (i.e., when price goes up, quantity demanded goes down, and vice versa), price elasticity is generally expressed with a minus sign. Thus, if the price elasticity is, say, –0.4, then for each (continued...)

41. In a 2001 Oregon rate design proceeding implementing a $64.2-million revenue reduction for Qwest, Qwest had *opposed* the use of a price elasticity factor in adjusting for demand stimulation following its proposed 42% reduction in intraLATA toll prices.[55] Qwest rejected other parties' recommended price elasticity factors of -0.3632 (advocated by the Oregon PUC Staff) and -0.5 (advocated by AT&T and WorldCom).[56] Although Qwest refrained from calculating an own-price elasticity in that proceeding, Qwest did suggest that, absent a definitive study, an own price elasticity for intraLATA toll of -0.2 "may be a more reasonable conclusion."[57] Note that all of these estimates suggest *highly inelastic* own-price elasticities, with the –0.2 figure suggested by Qwest being the most inelastic of the various values that had been put forth. While the presence of consequential intermodal competition would imply a relatively high *cross-price elasticity* between wireline long distance and the purported intermodal substitutes, a high cross-price elasticity would also imply a relatively elastic own-price demand if consumers truly viewed the alternative forms of telecommunications as true substitutes for traditional wireline voice long distance calling. The highly *inelastic* demand being claimed by Qwest and by

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54. (...continued)
1% drop in price, quantity would be expected to increase by 0.40%, all else being equal.

55. In the Matter of the Application of Qwest Corporation for an Increase in Revenues, Oregon PUC Docket UT 125, Phase II, Direct Testimony of David Teitzel on behalf of Qwest Corporation, November 15, 2000, at 37-39.

56. In the Matter of the Application of Qwest Corporation for an Increase in Revenues, Oregon PUC Docket UT 125, Phase II, Rebuttal Testimony of Aniruddha Banerjee on behalf of Qwest Corporation, May 3, 2001, at 39-42.

57. *Id.*, at 43.

other parties with respect to long distance service belies Qwest's and the other BOCs' contentions that rampant substitution of services such as e-mail and VoIP for traditional wireline long distance calling is actually taking place.

42. Similarly, in a 2000 Arizona rate case filed by Qwest, the Company's initial filings sought reductions in intraLATA toll rates, yet again no adjustment was made to account for demand stimulation despite recommendations by ACC Staff and the Arizona Residential Utility Consumer Office for the use of an elasticity factor for that purpose.[58] Although Qwest's own witness conceded that "when Qwest reduces a toll price, such as the reduction in Residential Toll off-peak prices proposed in this Docket from $0.15 to $0.10 (a 33% decrease) an economist would expect that a large surge in demand would be the result,"[59] he went on to assert that, based upon the Company's experiences with toll rate decreases in Washington, Wyoming and

58. By neglecting to account for demand stimulation, Qwest implicitly utilizes a highly inelastic price elasticity factor of 0. While witnesses for Staff and RUCO recommended that the effects of demand stimulation for toll service be accounted for, neither witness advocated for a specific elasticity factor. Nonetheless, *any* such value these witnesses could have recommended would, by definition, be *less inelastic* than Qwest's factor of 0.

59. In the Matter of the Application of US West Communications, Inc., a Colorado Corporation, for a Hearing to Determine the Earnings of the Company, the Fair Value of the Company for Ratemaking Purposes, to Fix a Just and Reasonable Rate of Return thereon and to Approve Rate Schedules Designed to Develop Such Return, Arizona CC Docket No. T-01051B-99-0105, Rebuttal Testimony of David Teitzel on behalf of Qwest Corporation, August 21, 2000, at 24.

Nebraska "[t]here is no fact-based reason to expect that intraLATA long distance call volumes in Arizona will be stimulated in response to Qwest's price proposal in this docket."[60]

Wireless

43. All BOC commentors cite wireless "substitution" as a viable alternative to wireline long distance service. The BOCs claim that competition from this arena will serve as a check on their long distance wireline long distance prices. The BOCs ignore their own substantial involvement in wireless as well as the effect of "bundling" efforts between their own wireline and wireless operations.

44. As the FCC noted in its recent Wireless Competition Survey, wireless is not yet a full substitute for wireline service. Specifically, the Commission cited studies where consumers indicate a high level of specific quality of service problems with wireless calls:

> GAO also estimated that, "about 47% of adult mobile phone users believed their call quality was improving, while about 5 percent believed that their call quality was getting worse." GAO also reported that "[d]espite the many mobile phone customers who appeared to be satisfied with their overall call quality, a number of survey respondents reported that they were experiencing specific problems." For example, "about one-third of customers could not complete 10 percent or more of their calls because they were in a cell where the carrier did not provide service." About 12 percent reported that such a problem occurred at least one-third of the time. In addition, just over 20 percent of respondents reported problems "getting a call through because [of a]

60. Arizona CC Docket No. T-01051B-99-0105, Rejoinder Testimony of David Teitzel on behalf of Qwest Corporation, September 19, 2000,

> fast busy signal or a message that says the call failed" or problems "with a call being cut off or dropped" at least 10 percent of the time. When examining consumer opinions, it is important to keep in mind that consumer perceptions of service quality can change independently of actual changes in network performance, as consumers' expectations evolve.[61]

Wireless call quality is not yet up to the level of wireline service and, indeed, it is likely that customers do not expect such a level of service quality precisely because they do not yet expect wireless to be a true substitute for wireline service.

45. The marketing plans of Verizon, SBC and BellSouth are also instructive. Each of these companies is bundling local, long distance, and wireless service, a tactic that allows the BOCs to benefit substantially from any wireless substitution. In a recent article discussing the wireless ventures of Verizon and Vodaphone, the *Wall Street Journal* noted that

> The companies [Verizon and Vodaphone] are also at odds in their strategies for owning wireless assets. Verizon Communications increasing uses the venture to prop up its declining land-line phone business, by bundling wireless at a discount with other services. Vodaphone considers land lines to have no future for consumers and wants little to so with them.[62]

61. *Implementation of Section 6002(b) of the Omnibus Budget Reconciliation Act of 1993 Annual Report and Analysis of Competitive Market Conditions With Respect to Commercial Mobile Services*, WT Docket No. 02-379, *Eighth Report*, Rel. July 14, 2003, at para. 88.

62. Latour, Almar and Drucker, Jesse, "Strains Between Telecom Giants Threaten Big Cellphone Venture," *The Wall Street Journal*, July 15, 2003, at 1.

If Verizon saw wireless as a true "substitute" for wireline service, there would be no incentive for customers to "bundle" wireline and wireless service together, since any price for wireline phone service above the price of a customer's wireless plan would bring no marginal benefit to the customer.

46. Verizon is not the only BOC bundling wireline with wireless. SBC and BellSouth both offer numerous bundles of wireline and wireless service. In addition, SBC and BellSouth, the owners of Cingular wireless, recently announced a bundled offer of wireless and wireline giving the customer the ability to "share" a single pool of minutes, between their wireless and wireline phone. In announcing this plan, BellSouth noted customer preference for wireless long distance pricing, but also the major drawback to wireless phone use– service quality.

> The service is designed for people who use the large number of night and weekend minutes typically found in wireless plans to make long distance calls from home. With the MinuteShare service, they will be able to take advantage of these minutes to make long distance calls while enjoying the clarity and quality of their home wireline phone.[63]

BellSouth's press release and MinuteShare service recognizes the quality differences noted by the FCC between wireless and wireline, and thus that the two services are not yet substitutes.

63. BellSouth Press Release, "SBC, BellSouth and Cingular join forces to erase distinction between wireline and wireless calls, offering shared bucket of minutes," June 5, 2003.

VoIP/Data Platforms

47. The rise of data technologies, especially VoIP, e-mail and instant messaging, has led the BOCs to claim that these services offer a substitute for long distance service, and therefore protection against BOC misconduct. However, in the vast majority of cases, consumer use of these services is completely dependent upon BOC bottleneck services (and therefore BOC bottleneck pricing). To utilize either e-mail or instant messaging, a consumer must purchase either dial-up or broadband internet service. According to Neilson research, approximately 64% of users access the internet through narrowband (dial-up) connections, while 36% utilize high speed connections.[64] Assuming that internet users utilize BOC facilities in the same proportion as the general residential access lines (96.6%), BOCs control the underlying facilities for some 61.8% of dial-up users. The FCC reports that DSL accounts for approximately 33% of all broadband users, and "other wireline" services account for 6%.[65] On this basis, nearly 76% of all residential internet users (39% x 36% + 61.8%) rely ultimately upon the BOC bottleneck for internet access. This overwhelming reliance upon the wireline facilities of the BOC belies the BOC claim that these same services are *substitutes* for the BOC's facilities.

48. Broadband internet access theoretically offers the additional substitute of VoiP. However, as noted by Deutsche Bank, "the threat from VoIP has been a little bit overblown and

64. http://www.nielsen-netratings.com/news.jsp

65. FCC, IATD, *High Speed Services for Internet Access: Status as of December 31, 2002*, at Table 1.

we certainly do not see a step-change in industry dynamics — at least for the next five years."[66] Additionally, BOC pricing strategies for high speed access ensure that VoIP is an unattractive substitute to traditional wireline service. The BOCs require that a customer ordering DSL *also* purchase local phone service, so any VoIP service provided to a customer who is served over DSL will be entirely redundant to the BOC's dial tone line service. This requirement severely limits the ability for VoIP providers to compete, severely limiting their utility as a "substitute" to wireline service.

Under the current cost allocation rules, BOCs have the incentive and ability to engage in cost shifting between their local and long distance operations.

49. Unlike AT&T in 1995, the BOCs *are not stand-alone long distance companies*. Unlike the post divestiture AT&T, the BOCs' integrated provision of local and long distance service (especially while access charges remain priced at multiples of costs) affords them with a unique advantage over competing stand-alone IXCs. As I discussed at length in my June 30 Declaration, BOCs are able to effectively ignore the imputation of access charges, gain significant market share for a tiny fraction of the sales and marketing costs confronting stand-alone rivals by exploiting their legacy relationships with monopoly local service customers, and avoid significant billing and customer care costs by "piggy-backing" them onto existing BOC ILEC functions and assigning virtually all joint local/long distance costs to their monopoly local service operations.

66. Deutsche Bank Study, at 67.

50. Indeed, although the BOCs argue that they are entitled to pursue and benefit from potential economies of scope by providing local and long distance services on an integrated basis, they are distinctly *not* entitled to confer 100% (or close to 100%) of those integration gains upon their competitive long distance operations. In fact, such treatment is expressly prohibited by Part 64 of the FCC's Rules, which require an apportionment of costs between regulated and nonregulated ILEC services on the basis of fully distributed cost. Section 272(b)(5) requires "arm's length" transactions between a BOC and its long distance affiliate, and thus supersedes the Part 64 cost allocation as long as the Section 272(a) separate affiliate requirement remains in effect. However, once that requirement has been allowed to sunset and the BOC proceeds to fully integrate and absorb its long distance business into its monopoly local service operations, strict enforcement of Part 64, only possible with the detailed cost support data required by dominant carrier regulation, will be the only means by which the Commission can assure that the BOC is not using its legacy monopoly local service operations to support and to cross-subsidize its competitive long distance business.

51. In its comments, Qwest relies upon the requirements of Part 64 to prevent cost misallocation.[67] However, without dominant carrier regulation of the BOCs' long distance services, there is no practical means by which the Commission will be able to detect, on an ongoing basis, noncompliance with Part 64. If customer service representatives, customer databases, operations support systems, billing and collection systems, and other BOC ILEC

67. Qwest Comments, at p. 19-20.

resources are utilized jointly to provide local and long distance services, the Commission's cost allocation rules would require that the joint costs of those resources be spread ratably across both service categories, rather than being made available, without charge, to the nonregulated business activity.

52. Specifically, subpart I of Part 64 requires carriers to separate the costs of regulated activities from those of nonregulated activities, and sets forth broad rules for allocating such costs. The cost allocation rules also provide that a telecommunications carrier may not use services that are not competitive to subsidize services subject to competition.[68] However, even if one could assume the BOCs' complete technical compliance with the principles set forth at Part 64, these rules leave substantial room for improper and anticompetitive allocation of costs whenever regulated and nonregulated activities take place on a fully integrated basis.

53. Carriers are required to assign costs directly to regulated or nonregulated activities "whenever possible."[69] The Commission's rules recognize, however, that not all of a carrier's costs are directly assignable. Under Part 64, all costs not directly assignable are considered "common" costs. The rules require the carrier to group common costs into "homogeneous cost categories" and then assign each cost category based upon a "hierarchy" of cost allocation principles:

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68. 47 CFR § 64.901(c)

69. 47 CFR § 64.901(b)(2).

(i) Where possible, the carrier must allocate a category of common costs "based upon direct analysis of the origin" of those particular costs.

(ii) If this is not possible, the allocation shall be based upon an "indirect, cost-causative linkage to another cost category (or group of cost categories) for which a direct assignment or allocation is available."

(iii) If neither of the first two methods are feasible, then the carrier must use "a general allocator computed by using the ratio of all expenses directly assigned or attributed to regulated and nonregulated activities."

If these rules are not vigorously enforced, they leave the BOCs with significant discretion that can be used to shift costs from its long distance operations to its regulated activities.

54. Moreover, although Part 64 requires the ILECs to provide a more detailed explanation of their actual cost allocations in their cost allocation manuals ("CAMs"), there has been little scrutiny of the CAMs, and there would be little or no scrutiny at all over a "non-dominant" long distance operation. The biennial Section 272 audits are supposed to identify any cost accounting abuses, but once the Section 272 affiliate ceases to exist as a separate corporate entity, the effectiveness of biennial audits — if any — will be severely undermined.

55. In any event, an "audit" must *by its very nature* take place *after-the-fact*. At best, it can detect accounting irregularities that have already taken place, but it cannot be relied upon as a means for *preventing* them from occurring to begin with. By the time an after-the-fact audit is completed and its results analyzed and adjudicated, unlawful misallocations and cross-subsidizations may persist for a number of *years* before remedial action is taken.

56. As dominant carriers, BOCs would be required to file tariffs and to supply the Commission with cost data in support thereof. This cost support data would allow the Commission and competitors to scrutinize the Part 64 allocations on a more granular level than available in the high level ARMIS filings. As currently filed, ARMIS cost allocation data provides no data disaggregated enough for scrutiny of allocated long distance costs. In addition, the aggregate nature of the Part 64 data currently provided makes it impossible to compare the allocation of costs associated with the provision of long distance service to the actual long distance plans offered. The only way for the Commission to determine if the properly allocated costs for long distance services provided by the BOCs are less than the price charged is with granular, *rate plan specific* cost support documents and tariffs filed on a minimum of 15 days' notice as required by dominant carrier regulation. Through this detailed cost support, interested parties would have an opportunity to protest an unlawful tariff and seek its suspension and investigation by the Commission. Among other things, the BOC would be *required* to demonstrate that, on a service by service basis, such tariffs comply with Part 64 cost allocation rules and other nondiscrimination provisions of the 1996 *Act*.

BOC claims that price caps on local services remove the incentive for the BOCs to shift costs ignore the reality of state price cap plans.

57. Each of the BOCs and Profs. Carlton *et al.* each claim that the application of price cap formulas "lessen or eliminate the relationship between an ILEC's reported costs and the prices it can charge for regulated services."[70] SBC notes the finding made by this commission regarding the effect of price caps. According to SBC:

> Concerns about cross subsidization are a relic from the past: when BOCs were under rate of return regulation, and, to a lesser extent, price caps with sharing regulation. Thus, in the *Non-Accounting Safeguards Order*, the commission stated that the BOC may have an incentive to allocate improperly to its regulated core business costs that would be attributable to its competitive ventures 'if the BOC is regulated under rate of return regulation, a price caps structure with sharing (either for interstate or intrastate services), a price caps scheme that adjusts the X-factor periodically based on changed in industry productivity, or if any revenues it is allowed to recover are based on costs recorded in regulated books for accounts.' None of those circumstance is present today, when BOCs are generally regulated under a pure price cap regime(without sharing)."[71]

BellSouth takes this a step further and claims that, as a result of price caps, not only is dominant carrier regulation unnecessary, but so are the Part 64 allocation requirements discussed above.[72] BellSouth claims that Long Distance should be a "regulated" entity for cost allocation purposes,

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70. Carlton *et al*, at para 66; SBC Comments, at 45; Verizon Comments, at 19; BellSouth Comments, at 20; Qwest Comments, at 15.

71. SBC Comments, at 45.

72. BellSouth Comments, at 21.

removing the need to allocate costs between local and long distance. That, of course, would eliminate any requirement for a BOC to allocate costs as between local and long distance, and make detection of deliberate misallocation virtually impossible to the extent that the remaining cost accounting requirements, set out at Part 32 of the Commission's rules, do not contemplate any detailed service-by-service cost accounting or reporting.

58. In fact, BOCs are often regulated in ways that the Commission has noted give incentives to misallocate costs. Seven states currently have some version of Rate of Return (or mixed rate of return and price cap) regulation.[73] An additional eight states are either currently reviewing their Price Cap plans, have price cap plans that come up for review periodically, or have plans that will expire (and thus provoke review) within the next five years.[74] Even where no formal schedule for price cap review proceedings has been established, ILECs may nonetheless petition for a review, modification, or even elimination of price cap regulation in the event that an earnings deficiency arises for whatever reason, including for example, the misallocation of costs of competitive services into the monopoly service category. I discussed the impact of this treatment of price caps, and its inability to forestall cost shifting, at length in my June 30, 2003 Declaration.[75] In order for price cap regulation to prevent or even limit a BOC's ability to engage in cross-subsidization of competitive services by supranormal profits generated from

73. Alaska, Arizona, Hawaii, New Hampshire, and Washington.

74. California, Colorado, Minnesota, Nevada, New Mexico, South Dakota, Texas and Utah.

75. Selwyn June 30, 2003 Declaration, at paras. 97-103.

monopoly services, the price adjustment mechanism would itself need to be properly specified so as to limit both the BOC's ability to earn supranormal profits (and thereby acquire the "engine" for cross-subsidization), and the BOC's ability to seek extraordinary rate relief or a major revision in the price adjustment mechanism in the event that, having shifted costs of its competitive operations to its monopoly services, it sustains an earnings deficiency in the monopoly service category. In some states, BOCs have been permitted to remove highly profitable yet largely noncompetitive services from their price cap plans (e.g., the yellow pages directory publishing operations) and have then sought reductions in or elimination of the productivity offset ("X") factor as a result of the (seemingly) reduced level of earnings.[76]

BOC claims that "predation is rarely a profitable strategy" are not supported by modern economic theory and assume conditions that are demonstrably absent in the case of the BOCs.

59. Professor Carlton *et al* assert that "[t]he foremost reason [for the Commission not to be concerned with the ILECs incentive or ability to engage in a price squeeze] is that it is widely recognized that predation is rarely a profitable strategy."[77] Note that the only specific authority advanced by Carlton *et al* in support of their "widely recognized" assertion is *their own prior*

76. In 1997, then-Bell Atlantic was permitted by the Pennsylvania PUC to shift its Pennsylvania directory publishing activity out of regulation, and in so doing reduced its reported intrastate rate of return from 16.07% in 1996 to 11.02% in 1997 (from Verizon 10-K Annual Reports). Verizon is currently asking the Pennsylvania legislature to eliminate altogether the X-factor from its price cap plan. Pennsylvania Telephone Association draft legislation, House Bill 30. Section 3015.

77. Carlton *et al*, at para. 54

writing.[78] However, a review of recent economic literature *by authors other than the BOCs' Declarants* flatly contradicts this claim.[79] In fact, Carlton *et al* seem to be relying upon older economic studies and upon the courts' interpretation of those studies, conveniently ignoring new evidence to the contrary.

60. Those courts have relied upon economic theory, now 25 years old, to make judgments regarding the supposed rationality of firms' actions, relying upon early literature, such as Bork (1978) and McGee (1958, 1980), that found predatory pricing to be irrational economic behavior.[80]

61. However, that notion of "irrationality" is certainly not universally shared outside of Chicago. Klevorick argues, for example, that the courts have entirely ignored the newer equilibrium (or game theoretic) models. In fact, Bolton, Brodley and Riordan wrote recently that

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78. Carlton *et al*, at footnote 51, citing *Modern Industrial Organization* by D. Carlton and J. Perloff.

79. A body of economic theory challenging the notion that predation is rare has been developed over the past twenty years. This work includes, but is not limited to, the following: Patrick Bolton, Joseph F. Brodley and Michael H. Riordan, "Predatory Pricing: Strategic Theory and Legal Policy,:" The Boston University School of Law Working Paper Series, Working Paper 99-5 (January 29, 2000) (also published in Georgetown Law Journal 88:2239-2330); Aaron S. Edlin, "Stopping Above-Cost Predatory Pricing," *Yale Law Journal* 111 (January 2002): 941-991; Alvin K. Klevorick, "The Current State of the Law and Economics of Predatory Pricing," 83 *American Economic Review (*AEA Papers and Proceedings 1993): 162-167; Garth Saloner, "Predation, mergers, and incomplete information," *Rand Journal of Economics*, Vol. 18, No. 2 (Summer 1987): 165-186.

80. Klevorick, at 166.

> ... modern economic analysis has developed coherent theories of predation, contravening earlier economic writing claiming that predatory pricing conduct is irrational. More than that, *it is now the consensus view in modern economics that predatory pricing can be a successful and fully rational business strategy*; and we know of no major economic article in the last 30 years that has claimed otherwise. In addition, several sophisticated empirical case studies have confirmed the use of predatory pricing strategies. But the courts have failed to incorporate the modern writing into judicial decisions, relying instead on earlier theory no longer generally accepted.[81]

Economists have developed new theories beginning in the early 1980s challenging the old Chicago School views on predatory pricing. These new theories coincided with the evolution of modern game theory, which has allowed economists to develop more complex models of firms' behavior in markets:

> This new body of research challenges the static framework of perfect information on which McGee [and thus the Court] had relied. The new analysis explains predatory pricing in a dynamic world of imperfect and asymmetric information in which strategic conduct can be profitable.[82]

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81. Bolton *et al*, at 1. At footnote 2, the authors state: "Prior papers suggesting judicial evaluation of predatory pricing in light of modern strategic theory include Alvin K. Klevorick, *The Current State of the Law and Economics of Predatory Pricing*, 83 Am. Econ. Rev. 162 (Papers & Proceedings, 1993); Janusz A. Ordover & Garth Saloner, *Predation, Monopolization, and Antitrust*, in 1 Handbook of Industrial Organization 537 (Richard Schmalensee & Robert D. Willig, eds. 1989) (citing earlier work by Oliver Williamson and others); Richard Craswell & Mark R. Ratrik, *Predatory Pricing Theory Applied: The Case of Supermarkets vs. Warehouse Stores*, 36 Western Reserve L. Rev. 1, 34-47 (1985)." See, also, Klevorick, at 162.

82. Bolton *et al*, at 10.

These *new* theories explain why predatory pricing is still observed in the "real world" and why it remains a "rational, profit maximizing strategy."[83]

62. The Carlton *et al* Chicago School position regarding predatory pricing is founded upon the concept of perfect information — an important theoretical concept, but one that often fails to capture the realities of the market. The Chicago School theories fail where asymmetric information has a role to play. As Saloner notes, there is a "large and growing literature that illustrates that when one abandons the assumption of complete information, there are numerous ways in which rational predatory pricing can arise."[84] None of the new writings would suggest that the Chicago School view is incorrect in a simple market, but "in more complex, realistic market situations, such as those with imperfect information about costs or about market toughness, aggressive pricing can yield significant long-run benefits to the incumbent firm."[85]

63. Critics of the courts' adherence to the Chicago School theory regarding predatory pricing argue that the continued reliance upon the work of McGee and Bork is due to the

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83. Bolton *et al*, at 10-11, citing Janusz A. Ordover & Garth Saloner, "Predation, Monopolization, and Antitrust," in *Handbook of Industrial Organization* (Richard Schmalensee & Robert D. Willig, eds. 1989).

84. Saloner, at 183.

85. Edlin, at 955-956.

complex nature of the newer economic theories.[86] The fact remains that the statement by Carlton *et al* that there exists wide recognition that "successful predation is rare" is simply unfounded. Indeed, a recent ruling by the Tenth Circuit underscores this point:

> Recent scholarship has challenged the notion that predatory pricing schemes are implausible and irrational. See, e.g., Patrick Bolton et al., Predatory Pricing: Strategic Theory and Legal Policy, 88 Geo. L.J. 2239, 2241 (2000) ("Modern economic analysis has developed coherent theories of predation that contravene earlier economic writing claiming that predatory pricing conduct is irrational."). Post-Chicago economists have theorized that price predation is not only plausible, but profitable, especially in a multi-market context where predation can occur in one market and recoupment can occur rapidly in other markets. See Baker, supra, at 590.
>
> Although this court approaches the matter with caution, we do not do so with the incredulity that once prevailed.[87]

64. A central feature of the Carlton *et al* assessment that predation would not be profitable for the BOCs is rooted in the patently incorrect *assumption* that in order to engage in predatory pricing the BOCs would have to sacrifice *current* profits on the expectation that these short-term losses would be more than made up through future supracompetitive profits that would become available once the BOCs' rivals had exited the market. That view, however, is rooted in the patently incorrect *assumption* that the BOCs would be unable to recover their current losses from

86. Edlin, at 956; Bolton *et al*, at 12.

87. *US v. AMR,* ___ F.3d ___, 2003-3 Trade Cases ¶74,078 (10th Cir 2003), slip. op. at 10-11.

predation through higher rates in the future, because were they to attempt to raise prices once rivals exited the market, the rivals would immediately reenter and push BOC prices down. This theory would require, at a minimum, (a) that rivals would immediately reenter the market (after having exited it) as soon as the BOCs attempted to increase prices in the future, thereby foreclosing post-predation profit recoupment, or (b) that the BOCs have no ability to *cross-subsidize* current predatory pricing initiatives with excess profits generated by other BOC services. In reality, of course, *neither one of these prerequisite conditions exists*.

65. As I have discussed at length in my June 30, 2003 Declaration, BOCs have sufficient pricing flexibility within existing price cap regimes to easily finance a predation strategy *out of current profits from services over which they maintain near-absolute monopolies*. These include, in particular, switched and special access services that the BOCs furnish to the very same rival carriers that are the targets of the BOCs' predatory pricing initiatives. Indeed, the ability to raise their rivals' costs while using the excess profits generated thereby to fund below-cost pricing of competitive services works to subject nonaffiliated rivals to a *double-barreled* attack, where the rivals' own payments to the BOC for monopoly access services are then used by the BOC to create the price squeeze.

66. The second prong of the Carlton *et al* unprofitability-of-predation theory requires that BOC rivals, once having been pushed out of the market by an effective BOC price squeeze strategy, would nevertheless rapidly reenter the long distance market were the BOCs to raise long distance prices. This utterly fanciful notion ignores the realities of the capital markets, the

formidable barriers that a reentry attempt would confront with respect to customer acquisition, and actual IXC experience in acquiring customers immediately following implementation of equal access where the then-incumbent, AT&T, had *none* of the local service market power advantages that the BOCs possess today.

67. For starters, in light of recent experience with telecommunications start-up ventures, there is almost no likelihood that investment capital would be made available to finance any consequential IXC reentry initiative. In addition to the enormous customer acquisition costs that any reentry attempt would necessarily face, the threat of a repetition of a BOC predation strategy following such reentry would be more than sufficient to chill any serious investor interest in such a venture. Indeed, this is precisely the sort of game theory perspective that Prof. Carlton and his Chicago School colleagues overlook when claiming that successful predation would be impossible. Moreover, by limiting their focus to the seemingly abundant interexchange network capacity that presently exists, Carlton *et al* ignore the much larger component of reentry costs — the *reacquisition of customers who will have switched to the BOC* for their long distance service and the continuing obstacles that an IXC that is not also offering local exchange service would face when competing with BOC bundled local/long distance packages. As I noted at para. 8 *supra*, in each of the states in which BOC long distance entry had occurred, the BOC had succeeded in capturing more market share in just 24 months than all of the non-AT&T inter-exchange carriers combined had been able to take from AT&T after *ten years* following the full implementation of equal access. Once the BOCs have forced their nonaffiliated rivals out of the residential/small business long distance market, those firms will have no realistic ability to

rapidly and successfully reenter the market in response to increased BOC long distance prices, and will be unlikely to undertake any such reentry attempt. As such, the BOCs will be able to recoup profits foregone while engaging in predation once they have succeeded in forcing their competitors out of the market.

BOC claims that they are not engaging in predation and that they could not engage in predation are also belied by the very same investment analyst reports that Prof. Carlton *et al* cite as authority for several of their other contentions.

68. Profs. Carlton *et al* additionally claim that predatory strategy would not succeed in the long distance market as a result of the presence of several large, established rivals, and the available capacity of long distance networks in theory allows new competitors to enter the market in the even of a price increase. However, despite this theoretical assertion that predation is unlikely, Profs. Carlton *et al* chose to ignore evidence presented in the Deutsche Bank study that BOCs are indeed engaging in predation with the expectation that their size and local customer base will allow them to kill their competition. As Deutsche Bank notes, "... neither UNE providers, independent wireless, DSL operators nor cable MSOs have anything approaching the RBOCs' financial capacity or customer reach. In the game of 'last man standing,' the RBOCs will be that man."[88]

69. Deutsche Bank concludes that BOCs are exerting significant average revenue per minute pressure with their current pricing plans. The analysts conclude, "We see no end to this

88. Deutsche Bank Study, at 3.

pricing strategy since the RBOCs are playing a market share, rather than revenue-maximization, game."[89] Under the Carlton theory that predation is an unlikely tactic for BOCs, a BOC would never "play a market share, rather than revenue maximization game." The only reason for the BOCs to price their services at a price that is less than revenue maximizing would be if they believed that the increased market share that would result from their "buy-in" pricing strategy could be sustained after rivals exited, and did not reenter, the long distance market, affording the BOCs ample opportunity to recoup any profits that they may currently be foregoing.

Elimination of structural separation requirements would vastly enhance the BOCs' ability to engage in price and non-price discrimination against rivals with respect to access to the BOCs' monopoly local networks.

70. The BOCs and their Declarants argue that the BOCs' *ability* to engage in cost shifting, price and non-price discrimination would not be affected by the elimination of dominant carrier regulation. For example, Prof. Carlton *et al* suggest that:

> The incentive and ability for ILECs to engage in non-price discrimination in providing rival long distance carriers access to local telephone networks *depends on the ability of long distance firms and regulators to detect such actions as well as the penalties that result if discrimination is detected*. Expiration of the structural separation requirements, however, affects only how ILECs structure their internal operations, not their incentive or ability to engage in non-price discrimination.[90]

89. Deutsche Bank Study, at 52.

90. Carlton *et al*, at para. 46, emphasis supplied.

As the Professor sees it, the BOCs's ability to engage in non-price discrimination against their rivals rests upon the extent to which they can successfully follow the "eleventh commandment" — i.e., *"thou shalt not get caught."* What Prof. Carlton and his colleagues seem to be suggesting, in fact, is that the BOCs *can be counted upon to engage in non-price discrimination* so long as such conduct can go undetected *and*, if detected, so long as the penalties that would then be imposed are small relative to the potential economic gains that might result from such conduct.

71. It's hard to find fault with this reasoning. Acting in their own self-interest, the BOCs will persist in "pushing the envelope" until blocked. Where we seem to disagree is how quickly that will occur and, more specifically in the context of this proceeding, whether elimination of dominant carrier regulation will affect the likelihood that such conduct would be detected and, if so, the likelihood that the penalties will be sufficiently great as to deter such conduct in the first place.

72. Of course, no one has ever suggested that dominant carrier regulation of BOC long distance services will preclude or foreclose BOC attempts to discriminate against their rivals. To the contrary, such conduct persists *despite* the existence of regulations that are expressly designed to prevent it. Regulation does, however, facilitate detection, and provides the mechanism for remedial measures if such conduct *is* detected. I described above, detailed cost support data, including the allocation of cost between local and long distance services and associating costs with the appropriate end-user service are crucial to the detection of cost-

shifting, the enforcement of imputation requirements, and to avoid predation. Indeed, the only condition under which the removal of regulation would have no impact upon a BOC's ability to engage in anticompetitive acts is if regulation is utterly incapable of constraining such conduct to begin with. Under that reasoning, if the local police are unable to prevent all crime or to solve all crimes that do take place, then one might as well do without the police altogether. But if that is actually what Carlton *et al* are contending, then the solution is *not* to abandon regulation, but to strengthen it so that it can do the job that it was designed to do.

73. As I have discussed at considerable length in my June 30, 2003 Declaration, BOCs can and do engage in both price and non-price discrimination with respect to rival IXCs.[91] Where imputation rules are present — the case with respect to many intraLATA toll services that are provided by the BOC on a fully integrated basis with its local services — they are frequently *evaded* (e.g., by combining multiple services within the same imputation "test"), *avoided* (by imputing only the specific "access services" that the BOC itself utilizes when providing its competitive intraLATA toll service, which may be few or none), and *ignored* for purposes of setting the applicable retail price for the toll service. But at least there is an "on the books" requirement that an imputation test be made and that it be provided to the state commission as an integral component of the tariffing and ratesetting processes.

91. Selwyn June 30, 2003 Declaration, at paras. 74-103.

74. In principle, of course, the BOCs' Section 272 long distance affiliates are also subject to an imputation requirement. Section 272(e)(3) provides that:

> A Bell operating company and an affiliate that is subject to the requirements of section 251(c) ... shall charge the affiliate described in subsection (a), or impute to itself (if using the access for its provision of its own services), an amount for access to its telephone exchange service and exchange access that is no less than the amount charged to any unaffiliated interexchange carriers for such service

The statute is far from clear, and the Commission has never defined, precisely how the "amount for access to [the BOC's] telephone exchange service and exchange access" is to be determined.

75. Where the retail long distance service is provided by a separate Section 272 affiliate subject to the Section 272(b)(1) "operate independently" requirement, the affiliate must purchase *exactly* the same kinds of access services that a nonaffiliated IXC would be required to purchase in order to provide its retail services. Hence, so long as the separate affiliate requirements (such as Section 272(b)(5)) and "operate independently" requirements remain in effect, at least with respect to access services, the affiliate long distance entity and nonaffiliated IXCs each deal with the BOC's ILEC entity for access services on a roughly equivalent basis. That will not be the case, however, once full integration is allowed.

76. We can look to the situation relating to *intraLATA* toll services as indicative of what might arise were the BOCs permitted to provide long distance on a fully integrated basis. In fact, precisely this type of integration exists today, with respect to *intraLATA* toll services. With

respect to imputation, BOCs have argued that they are only obligated to impute the tariff rate for the access services *that they themselves utilize* in providing the retail toll service, and specifically *not* the suite of access services that a rival nonaffiliated IXC would utilize when providing intraLATA services to its retail customers. And because their local and intraLATA toll networks are operated on a fully integrated basis, the BOCs frequently do not use the same, or perhaps *any*, of the specific access services and functions that their nonaffiliated rivals are forced to utilize. For example, when an intraLATA call originated by a BOC end user is routed to an IXC, it will typically be routed from the originating end office via common transport to a BOC access tandem, then via dedicated transport to the IXC's Point of Presence ("POP") via dedicated transport, then back via dedicated transport to another (perhaps even to the same) BOC access tandem, and then over common transport to the terminating BOC end office (see Figure 1 below). If that same call is provided end-to-end by the BOC, it will either be routed via a direct end office trunk ("DEOT") between the originating and terminating end offices without any tandem routing at all, or *at most* will be routed via one local tandem switch (see Figure 2). In some cases, the two exchanges at the ends of the toll call may even be served by the very same end office switch, in which event the call is completed entirely on an intraswitch basis, without any common or dedicated interoffice transport or interoffice switching (see Figure 3).[92]

92. This might occur, for example, where the central office switches serving the two exchanges have been consolidated into a single switch entity, while the preexisting exchange boundaries and local calling areas remained intact. For example, Lewiston and Farmington, Maine, some 45 miles apart, are both served by the same Verizon host central office switch, LSTNMEASDS0 physically located in Lewiston. Calls between these two communities are subject to intraLATA toll rate treatment.

77. If the BOC does not itself utilize the same access services and access functions that it provides (at above-cost prices) to its non-integrated, non-affiliated rivals and is only required to impute to itself the equivalent tariff price for the services and functions that it actually uses (or is selectively exempted from imputation altogether), the rival carriers can and will be forced into a price squeeze if the price that they pay for the access functions that they use exceeds the amount that the BOC is required to impute.

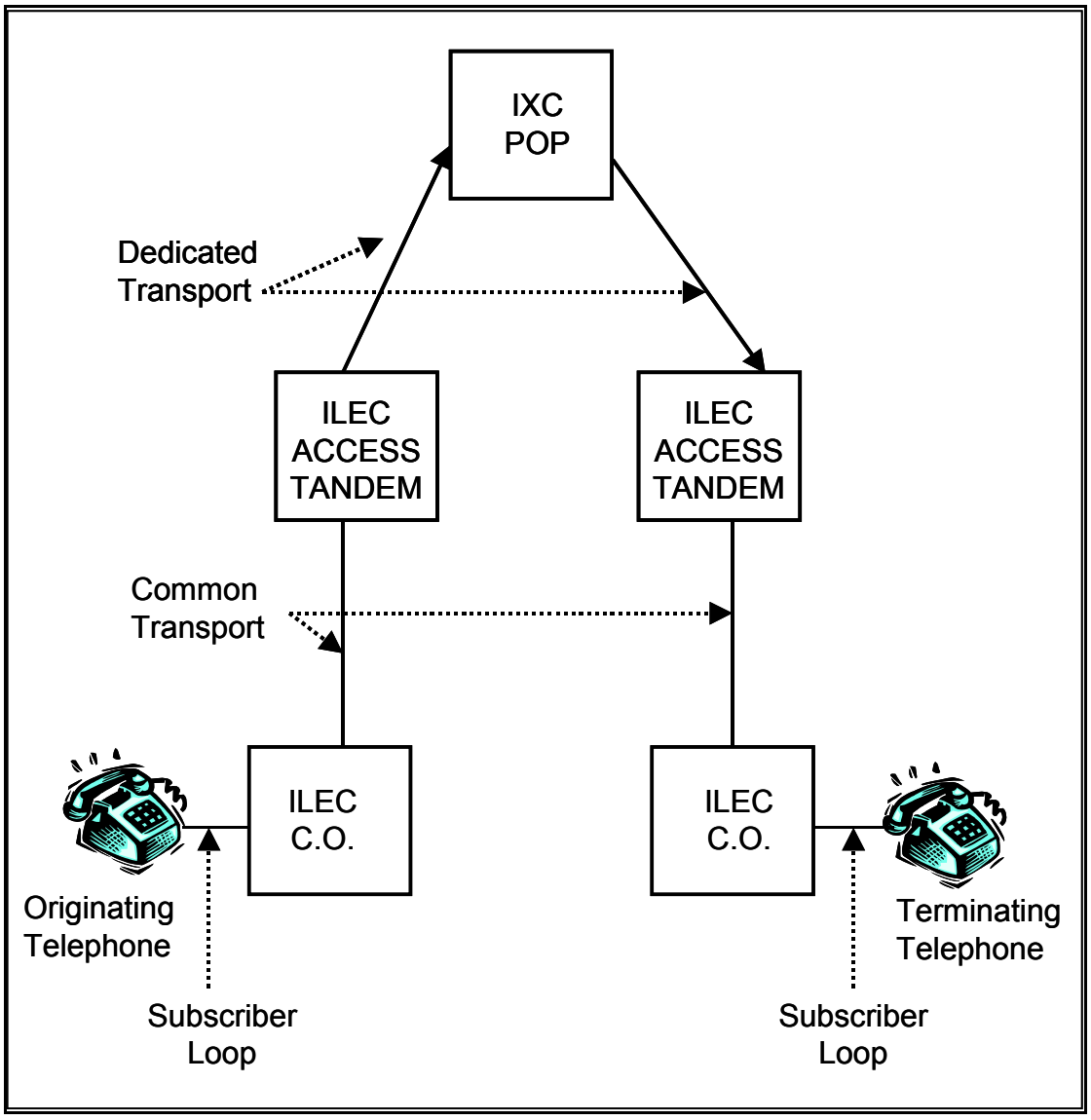


Figure 1. Routing of intraLATA toll call via IXC.

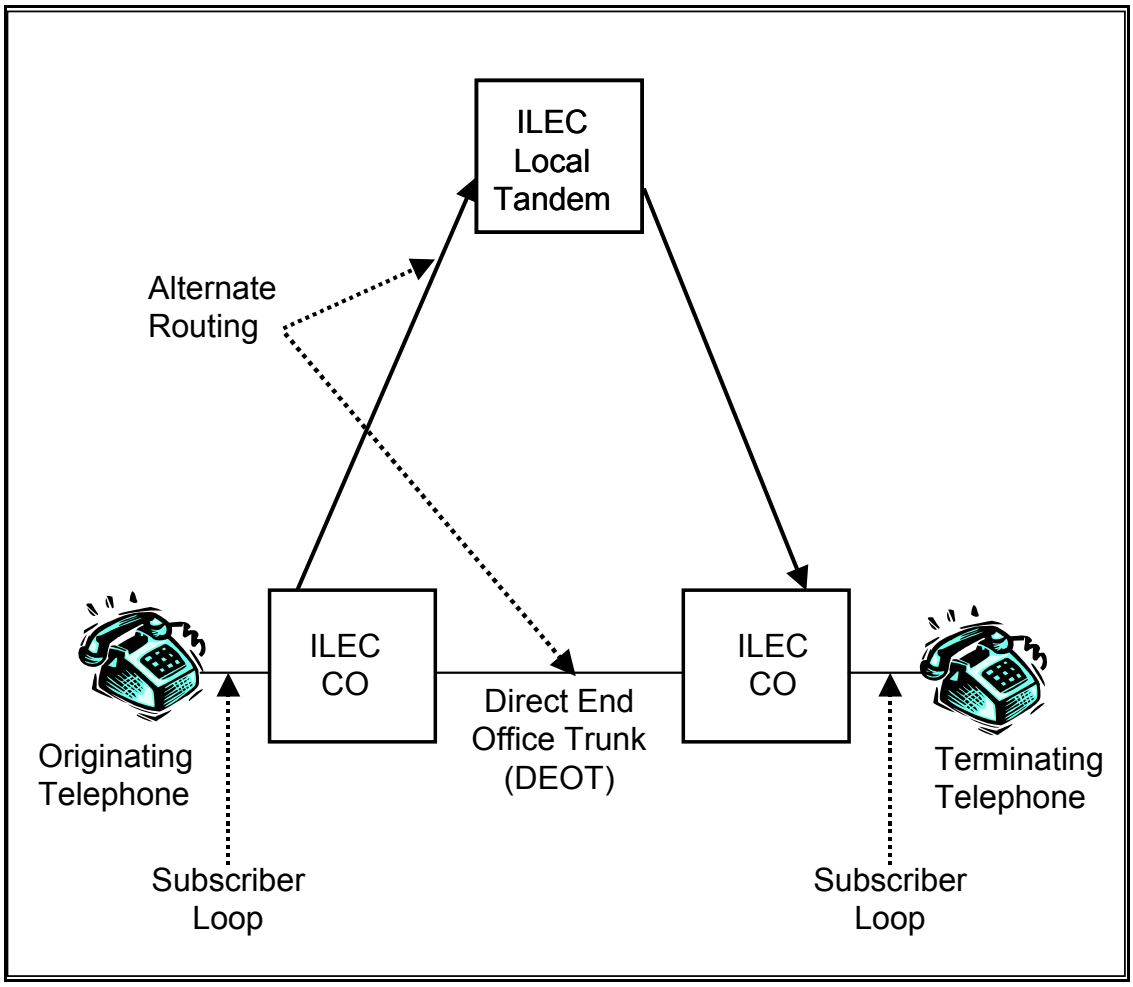


Figure 2. Routing of intraLATA toll call carried end-to-end by ILEC.

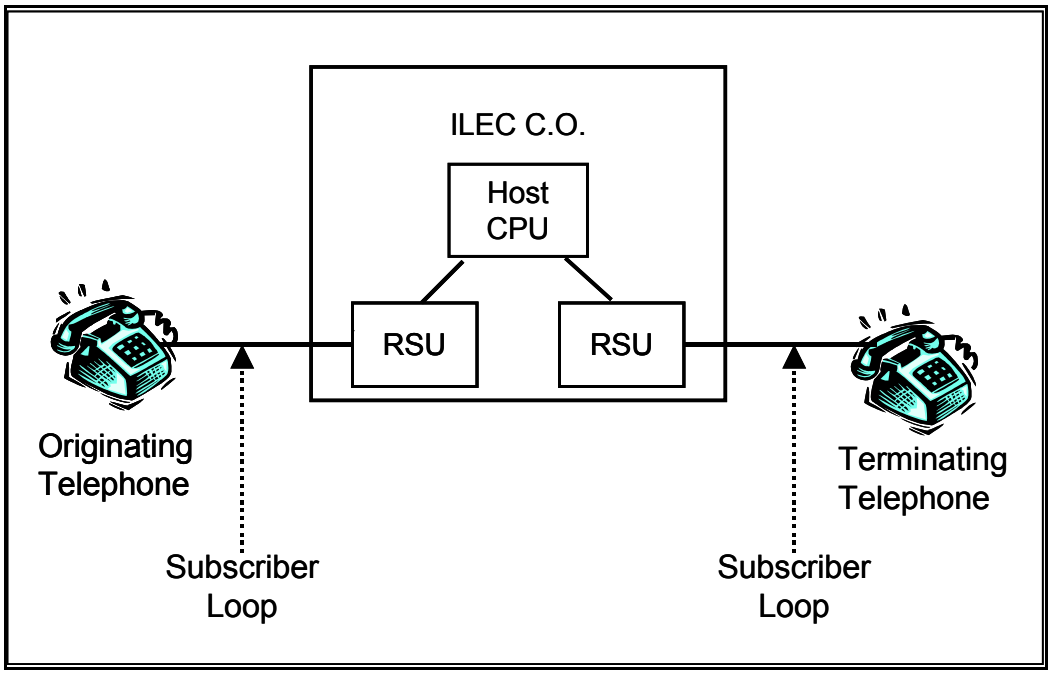


Figure 3. Routing of intraLATA toll call carried end-to-end by ILEC on an intraswitch basis.

78. Finally, even where the BOC's retail long distance price nominally "covers" the sum of access charges plus incremental non-access costs, a price squeeze may still result if the incremental non-access costs are determined by treating all joint costs as non-incremental to the long distance operation.

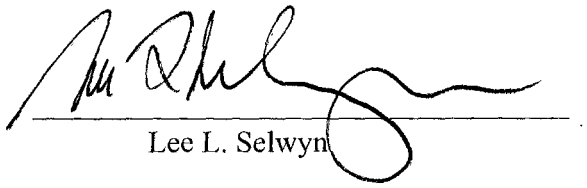
Conclusion

79. In its Comments, Verizon refers to the Commission's conclusion in its *LEC Classification Order* that "... dominant carrier regulation ... can stifle price competition and marketing innovation when applied to a competitive industry."[93] But the Commission also determined, in view of the separate affiliate requirements and safeguards of Section 272 and the near-zero long distance market share then being held by the BOCs, that dominant carrier regulation was *unnecessary* and that its burdens outweighed its benefits. But experience has taught otherwise. BOCs and other ILECs continue to overwhelmingly dominate the local exchange service market, providing the underlying facilities for more than 96.6% of all access lines in the nation. Since attaining in-region long distance entry, BOCs have amassed market share at an unprecedented rate, rapidly eclipsing competition in the long distance market while maintaining their continued dominance and market power with respect to local services. Whatever conclusions the Commission may have reached six years ago must be revisited and revised in light of conditions "on the ground" today. The BOCs' Declarants herein have readily *conceded* that BOCs have both the incentive and the ability to engage in anticompetitive conduct so long as

93. Verizon Comments at 2, citing *LEC Classification Order*, at paras. 89-90.

they do not get caught doing so. The BOCs' Declarants have advanced obsolete theories regarding predatory pricing that are premised upon theoretical "perfect" information flows and reentry opportunities were BOC predation successful in forcing rivals out of the long distance market. And finally, while the BOCs speak of dominant carrier regulation as "adversely affecting competition," they have failed utterly to demonstrate any factual basis for that speculation and, indeed, have failed to refute the opposite conclusion. Regulation of the BOCs as dominant carriers is critically important if *any* meaningful competition is to persist in the nation's local and long distance telecommunications sectors, and the gains from continued competition are easily worth whatever nominal "burdens" may arise as a result.

The foregoing statements are true and correct to the best of my knowledge, information and belief.



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